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Mr. Chairman, Mr. Lewis, and members of the committee, I appreciate the invitation to appear before you today. I would like to make six related points in my testimony:

1. Most state and local employees receive modest pension benefits, for which both they and their employers contribute annually during their working years.
2. The underfunding problems of most state pension systems can be addressed with relatively modest increases in state and local contributions from employers and employees, along with a set of sensible, moderate changes in benefits. In a handful of states with gross underfunding and a history of failure to make required contributions, more extensive changes are likely to be necessary, but those states are not typical.
3. Some of what has been widely published recently about current underfunding is related to market losses during the recent recession. Pension funds have already recouped two-thirds of those losses, but the asset averaging procedure (or "smoothing") used by the pension funds does not yet fully recognize the extent to which assets have bounced back.
4. Underfunding would appear to be much greater than pension funds report if pension fund liabilities were discounted at a "riskless rate." The debate over whether or not to discount liabilities using a "riskless rate," however, is distinct from the actuarial determination of the amount of funding that states and localities have to deposit into their pension funds to meet future obligations.
5. H.R. 567 is in many ways a "solution" in search of a problem — one that would override a careful process already well underway by the Government Accounting Standards Board to standardize state pension fund reporting and make it more transparent. In contrast to the GASB process, H.R. 567 would be likely to increase public confusion, could spook bond markets, and could lead states and localities to cut spending for education and other key areas — or raise taxes — more than necessary. It also would create a new federal bureaucracy to regulate something that should be "regulated" by market forces.
6. Moving state and local employees from defined benefit to defined contribution plans — an objective that some of the sponsors of H.R. 567 have said they would like to accomplish — would not address the funding problems public pension systems currently face. On the contrary, it generally would *raise* annual costs by making it harder for a state to pay down the existing liabilities for employees still in the defined benefit plan, because that plan would include fewer employees and fewer contributions going forward, while requiring additional contributions for the employees in the defined contribution plan.

What are State and Local Pensions?

Pension benefits are part of the compensation of most state and local employees. Each year, in addition to pay and other benefits, employees earn deferred compensation. Among state and local workers, 84 percent are covered by defined benefit plans, as compared to 47 percent of employees in private sector firms with more than 500 employees

Despite various newspaper headlines and talk show claims, public sector pensions are not particularly large. The average state and local public pension benefit is $22,653 a year, according to the Census bureau. It also is important to note that not all state and local sector workers have access to Social Security. For 27 percent of state and local employees, their pension is in lieu of Social Security. This includes more than 40 percent of all teachers and a majority of all public safety workers. Since these workers are missing one leg of the desirable three-legged stool of income to replace a reasonable portion of earnings during retirement — the three legs being Social Security, pensions, and private savings — their pensions are somewhat larger and push up the average.

Currently, employer contributions to state and local pension funds equal, on average, 3.8 percent of state and local budgets. This contribution is part of state and local operating budgets, while pension benefits themselves are paid from the accrued assets in the trust funds. Employer contributions accounted for 27 percent of the revenues to pension trust funds, employee contributions accounted for 13 percent, and investment earnings accounted for 60 percent in the period from 1982 to 2009.

Funding Status of State and Local Pensions

Pension funds in many states are underfunded, and some seriously so. This is a problem that needs to be addressed over time in most states, through some sensible measures, which I discuss below. More extensive changes are likely to be needed only in those states that failed in recent years to make the required contributions or that retroactively improved benefits without providing funding to cover the costs of those benefit improvements. These more troubled states include Illinois and New Jersey, as well as Colorado, Kansas, Kentucky, and Rhode Island.

There is an ongoing debate over just how seriously underfunded state and local pension funds currently are, as well as over whether they are sustainable over the next number of decades. This debate, which primarily centers on how the current value of future liabilities should be measured, has heated up as pension funds lost substantial assets in the recent recession (as well as in the 2001 recession) and therefore are currently reporting less than full funding.

Using conventional assumptions that follow the rules set forth by the Governmental Accounting Standards Board, the unfunded liability of state and local pension funds is approximately $700 billion. Using alternative assumptions based on discounting liabilities by what is known as the "riskless rate" – described below – the unfunded liability is more than $3 trillion.

Unfunded liability is calculated as the current value of future liabilities minus the value of assets on hand. It is worth looking at both sides of that equation.

Assets

About two-thirds of the $900 billion in assets that pension funds lost during the recent recession has now been recouped. Funding declined from $3.2 trillion in 2007 to $2.3 trillion in 2008, but assets had rebounded to close to $3 trillion at the end of 2010. Most pension funds, however, use a procedure called "smoothing," which phases in gains and losses in assets over a period such as five years to limit the volatility of their asset measure. Thus, 2008 losses will continue to be reflected in the smoothed measure of assets for a few more years, after which the growth of assets will become more evident.

The confusion over the amount of assets held by pension trust funds may lead to some over-concern about the funding status of the funds. For example, a report released last week by the Pew Center for the Study of States reported on funding status at the end of fiscal year 2009 (June 30, 2009 in most states and localities) and found that funding had dropped substantially from the previous year. But assets were much lower in the second quarter of 2009 than in the most recent data for the fourth quarter of 2010. Both the smoothing and the lag in reporting means that the well publicized results of the Pew study are significantly affected by the temporary dip in assets during the recession, and will likely change substantially as the assets in the funds regain ground and as the bad years work out of the smoothing formula.

Liabilities

The issues relating to the measurement of liabilities are more complicated.

Economists generally support use of the riskless rate in valuing state and local pension liabilities because the constitutions and laws of most states prevent major changes in pension promises to current employees or retirees; they argue that definite promises should be valued as if invested in financial instruments with a guaranteed rate of return, like Treasury bonds. State and local pension funds, however, historically have invested in a diversified market basket of private securities and received average rates of return much higher than the riskless rate – 8 percent on average over the past two decades. (A "riskless rate" would be about 4 percent or possibly less.) It also should be noted that most economists are *not* arguing that state and local pension funds should change their investment practices, liquidate their equity portfolios, and invest solely in bonds.

A key point to understand is that the issues of: 1) how states and localities should *value* their pension liabilities; and 2) how much they should *contribute* to their pension funds each year to meet their pension obligations are two separate issues, although they obviously are related. The estimate of more than $3 trillion in unfunded liabilities that results from use of the "riskless rate" does *not* mean states and localities should have to contribute that amount to their pension funds, since the pension funds very likely will earn higher rates of return over time than the Treasury bond rate — and that, in turn, means states can achieve pension fund balances adequate to meet future obligations without adding the full $3 trillion to the funds.

Implications for Budgets

Work done by the Center for Retirement Research at Boston College (CRR) finds, using GASB assumptions, that state and local contributions to pension funds would have to rise from 3.8 percent of state and local budgets to 5.0 percent of state and local budgets over the next 30 years to bring the pension funds to full funding. This assumes that no other changes are made in benefits or employee contributions to lower costs.

By contrast, CRR finds that contributions would have to rise to 9 percent of state and local budgets to fully fund pensions if a discount rate of 5 percent were assumed. Since many proponents of the riskless rate are suggesting using the rate for Treasury Bonds, and the yield on 30-year Treasury Bonds currently is below 5 percent, more than 9 percent of budgets would have to be devoted to pension contributions if the riskless rate became the basis for those contributions (again assuming that all else is held constant).

Implications of H.R. 567

In February, 2011 Congressmen Devin Nunes, Darrell Issa and Paul Ryan introduced legislation (H.R. 567) to require states and local governments to report their pension liabilities to the federal government using the "riskless rate" — defined as an interest rate tied to the Treasury bond rate — as the discount rate to determine their pension liabilities. Any state or local government not complying with this requirement would face a penalty of great severity — it would lose the ability to issue tax exempt bonds, which states and localities rely upon to finance infrastructure construction and related purposes.

In a number of ways, I think this bill is a "solution" in search of a problem. Most people would agree that there is a need to standardize state and local pension reporting and make it more transparent — and that process already is underway. Extensive work has been done on these matters by GASB, which is an expert, non-political board appointed by the independent foundation that oversees both private and public accounting standards in the country. The GASB board is composed of accountants and financial analysts, many of whom have served as state or local auditors or comptrollers; the board enjoys substantial respect in financial markets. GASB's work on new pension standards is now nearing completion, and it is on track to issue the new standards for state and local government reporting on the financial status of their pension funds late this year or next year.

The Nunes bill would effectively short-circuit and override the GASB process by issuing a federal edict on how pension funds are to report liabilities. It would be unsound policy to substitute heavy-handed and unnecessary federal intrusion for the GASB standards and the financial market discipline that induces state and local governments to comply with those standards.

There are a number of other, related problems with the Nunes proposal, as well, including:

- It could sow public confusion, as it would likely lead the public and many policymakers to believe that the amounts that states and localities need to deposit in their pension plans each year are substantially larger than the amounts actually needed. Misunderstanding of the level of contributions required could lead to excessive cuts in *other* parts of state budgets (such as education) and/or greater-than-needed tax increases in order to free up more room in state budgets for the greatly increased pension contributions; it also could generate pressure to end defined-benefit pension plans.

- The legislation could unnecessarily spook the bond markets, leading to higher borrowing costs for states and localities.

- A new federal bureaucracy would have to be created to gather, process, and verify the information for the nation's 2,550 state and local pension plans and to apply and enforce any federal penalties that would have to be applied under the legislation. The new bureaucracy would be created at a time when the federal government is trying to cut costs.

These important problems are discussed below in more detail.[1]

Short-circuiting and conflicting with GASB

For the past four years, the Governmental Accounting Standards Board — which sets standards for financial accounting for governments, just as the Financial Accounting Standards Board (FASB) does for private sector businesses — has been conducting extensive research and consultation with well over 100 stakeholders, including public hearings, to develop new pension financial reporting standards. The standards are expected to be promulgated next year. While GASB has no authority to *require* states and localities to follow its standards, bond raters and financial analysts generally look askance at governmental entities that do not comport with the standards. Thus, GASB standards typically become the *de facto* financial accounting rules for state and local governments, because of the discipline of the financial markets.

The new GASB standards have been issued in draft form. Assuming that the final standards will be similar to the most recent GASB draft, the new standards will provide for many fewer choices of methods and move state and local governments to issue annual statements of the financial position of their pension funds that are comparable to one another. Unlike the Nunes bill, the forthcoming GASB standard addresses a wide array of areas of pension financial reporting, including the liability accrual basis as well as other areas, in its effort to achieve accuracy and much greater uniformity.

In addition, while the Nunes bill requires use of the interest rate for Treasury bonds to determine the funding status of pension funds, the draft GASB standard explains that the liability amount that results from using the "riskless rate" to calculate fund liabilities does *not* reflect the amount that state and local governments need to deposit in their pension funds. The GASB draft said use of the riskless rate for determining state and local contribution levels would not be "…consistent with the view … that the present value of projected benefit payments should reflect an expectation of the employer's projected sacrifice of resources, reduced by the expected return on investments."

To estimate the amount of pension fund assets actually expected to be available to finance pension payments, the draft GASB standard calls for use of the actual expected rate of return, because it better reflects the level of contributions that will be needed. The GASB draft does require use of a lower interest rate for projecting benefit payments expected to have to be made after the projected point at which a plan's assets are expected to be depleted. For the portion of future liabilities for which current assets or expected contributions and associated earnings cannot be identified, the GASB draft standard uses an interest rate derived from an index rate for state and local governmental bonds of high quality.

Accordingly, the *overall* rate that the GASB draft would use to estimate the level of contributions that state and local governments need to make to their pension funds would be based on a *blend* of the expected rate of return on a fund's existing and expected assets *and* the rate of return on high-

[1] For a fuller description of the problems with this approach, see Iris J. Lav, *Proposed Public Employee Pension Reporting Requirements Are Unnecessary*, Center on Budget and Policy Priorities, March 14, 2011.

quality municipal bonds (which would be applied to the additional funding that will be needed). The precise blend would depend on various factors related to the funding status of the pension fund, but it is clear that less well-funded plans would be required to use a lower discount rate to reflect the greater risk to their ability to pay benefits.

A large amount of analysis and thought has gone into the development of the new GASB standards. The process of developing these standards has been one into which stakeholders and interested parties have had an opportunity to provide input and analysis, and the GASB Board has spent considerable time scrutinizing these submissions and various other analyses. When the final standard is issued, it is likely to have strong compliance.

Adding to Public Confusion

Given the complexities of determining the appropriate discount rate and understanding its meaning, there is risk that a federal rule that *mandates* valuation on the basis of the "riskless" rate would sow confusion between the unfunded liability valuation and the amounts necessary for state and local government to contribute to the plans. The public is unlikely to be able to distinguish between the valuation required under the legislation and the required annual contribution levels, especially if the large unfunded liability numbers derived under the legislation's reporting requirements are widely publicized. This may lead some policymakers to conclude that the levels of required contributions are unaffordable and the pension plans no longer viable when that is not the case.

More specifically, if states and localities are pressured to increase their annual pension contributions to meet the much larger contribution amounts that would be required if the "riskless" discount rate were used mechanically to calculate the contribution levels, any of several deleterious effects could result. States could end up cutting education or other priority investments in order to free up room in their budgets for pension contribution levels that exceed the amounts needed to cover future pension liabilities. Or, states could raise taxes more than is needed. Moreover, the overfunding of pension plans that ultimately would result could lead to demands for increased pension benefits that would not represent a sound use of resources.

Alternatively, if states and localities are pressured to raise their pension contributions to the levels that would be needed if pension funds actually invested solely in bonds, that could induce more states to abandon defined benefit pension plans altogether. That appears to be one of the goals of some of the bill's sponsors. Commenting on an identical bill introduced in the last Congress, a *Wall Street Journal* editorial said, "Their bill would encourage governments to switch to defined-contribution plans by revealing the true magnitude of their unfunded liabilities."[2]

To be sure, many states and localities do need to increase the amount of funding they deposit in their pension funds to address their unfunded liabilities. But they do not need the massive increases

[2] "Public Pension Hygiene Act," *Wall Street Journal*, January 22, 2011. Rep. Nunes also told a group of California government officials, "So what this will only set up, what the folks in the private sector have figured out a long time ago, was that you have to get away from the defined benefit plan (pensions) and somehow get to a defined contribution (401(k)-style plan)"; see Ed Mendel, "Pension Debt Bill: New Drive Toward 401(k)s," *Calpensions*, posted February 21, 2011. http://calpensions.com/2011/02/21/pension-debt-bill-new-drive-toward-401ks/

in contributions that would be required if pension funds were to invest solely in bonds and to receive the bond rate of return.

Potential for Spooking Bond Markets

Spooking bond markets could be another consequence of the confusion created by the Nunes bill. State and local bond markets have been volatile recently. In particular, an appearance on the television show *60 Minutes* by a financial analyst predicting 50 to 100 significant bond defaults this year — a claim that later was shown not to be supported by solid analysis and that is extremely unlikely to be borne out — is thought to have played a significant role in causing some investors to lose confidence in municipal bonds at the end of 2010 and beginning of 2011, resulting in a sizeable sell-off of those securities. States and municipalities have had to offer higher interest rates to sell their bonds because of this loss of confidence, a situation that is only now slowly turning around.

The potential of large and confusing unfunded liability numbers appearing on a federal government website could have a similar affect on the bond market, especially since those numbers would not represent the amounts that states and localities actually need to contribute to their pension funds to cover their obligations. Not every financial analyst, bond trader, or mutual fund investor understands the complexity of state and local pension financing and thus would know how to interpret these data. The legislation and the data it requires hold the potential to frighten potential investors unnecessarily and thereby result in higher interest costs for states and localities.

Creating a New Bureaucracy

Each of the 2,550 distinct state and local pension plans in the country provides information about its plan. The federal government does not collect or compile this information.

As a result, instituting the Nunes bill would necessitate creating a new bureaucratic entity within the Treasury Department to maintain information on active state and local pension plans, collect relevant reports from state and local governments, assure the timeliness of those reports, check them for accuracy and for compliance with the terms of the legislation and the implementing regulations, communicate with states and localities regarding any discrepancies, and enforce the penalties (described below) on states and localities that are out of compliance. This new bureaucracy would be created at a time when virtually everyone is looking for a way to cut federal government expenditures.

It is financial analysts and the securities markets that can effectively enforce discipline on the pension reporting of states and localities. Once the new GASB standards are in place, the strong market incentives for compliance with those standards will assure that the reported financial status of pension plans is comparable across plans. This is a clear example of a situation in which the operation and discipline of markets is preferable to the imposition of federal regulations.

A Common Sense Strategy for Improving Pension Funding

States' options to reduce the costs of their pension plans as a way to bring assets and liabilities into balance are somewhat constrained because key provisions of current pension promises to current employees are legally guaranteed in most states. Moreover, changes to public employees' compensation will affect the ability of states and localities to attract and retain workers. Currently, the pay of public-sector workers is below that of their private-sector counterparts: "Apples-to-apples" studies find that state and local workers are paid 4 to 11 percent less than private-sector workers with similar education, job tenure, and other characteristics.[3] Benefits, including pensions, make up some of that difference. States that slash benefits deeply for new workers (and current workers in states where that's allowed) run the risk of dissuading the best young workers from entering careers in education, health care, public safety, and other areas that are important for a state's long-term economic future.

Nevertheless, many states and localities have been taking a variety of actions over the past few years to improve the funding status of their pension funds. Some 11 states last year increased employee contributions toward their future pension costs, and 16 states made changes that will reduce benefits for future employees such as changing the formula used to set pension levels. (Several states fall in both categories.) In addition, a number of states reduced or eliminated cost-of-living increases in pension payments, primarily for future employees. Other states have made changes that will facilitate more consistent and adequate funding for pensions, such as requiring at least a minimum contribution every year. Most states in which there is significant underfunding are well aware of the problem and are moving to address it in a variety of ways.

These types of actions are among the steps that states and localities can take, within the current legal, fiscal, and economic framework, without throwing their budgets out of whack or harming their economies. I believe states and localities should:

- Act now to craft a plan to restore pension trust funds to solvency gradually. The long-term nature of the problem means that most state and local governments can fashion a plan that defers placing significant additional pressure on strained state budgets for a few years until state revenues have recovered from the economic downturn.

- Move carefully to change, as necessary, their methods for determining needed state and local contributions. Requiring much larger contributions now, while state budgets are still in crisis, would mean that states and localities would have to take even more resources away from other important areas like education (or raise taxes more) at a time when they are already cutting important services and investments deeply.

- Immediately change pension rules to reduce the potential for uncommon but damaging abuses

[3] See, for example, analysis of Current Population Survey data in Keith A. Bender and John S. Heywood, *Out of Balance? Comparing Public and Private Sector Compensation over 20 Years*, Center for State & Local Government Excellence (CSLGE), National Institute on Retirement Security, April 2010, page 7, http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7B03E820E8-F0F9-472F-98E2-F0AE1166D116%7D.PDF; and John Schmitt, *The Wage Penalty for State and Local Government Employees,* Center for Economic and Policy Research (CEPR), March 2010, http://www.cepr.net/documents/publications/wage-penalty-2010-05.pdf.

such as "double-dipping" (where, for example, a person claims a public pension while continuing to draw a government salary) and "spiking" (where employees artificially inflate their final year's earnings in order to boost their pensions).

- Gradually address under-funded pensions with a balanced combination of adequate contributions to pension funds by governments and employees (in the states where employees are not already contributing adequately) and restructuring of benefits as appropriate. For example, many states and localities are following the lead of the Social Security system and raising the age when an employee qualifies for a full pension to reflect the fact that people are staying healthier longer and living longer than in the past. For example, last year alone, 12 states upped their retirement ages including Illinois (to 67), Pennsylvania and Vermont (to 65), and Virginia (to match Social Security's full retirement age). In almost all states and localities, police, firefighters, and employees in other physically demanding jobs are allowed to retire with full pensions at a younger age than other employees.

- Continue to offer defined-benefit plans, since to do otherwise would actually make it harder for states to restore fund balance, as explained below.

Defined Benefit v. Defined Contribution Plans

The issue of whether states should close their defined benefit plans and switch over to offering defined contribution plans has received considerable discussion and deserves attention. There are a number of reasons why these conversions do not make sense from either a fiscal or retirement security perspective.

First, closing a defined-benefit plan to new hires has no effect on a state's current unfunded liability, so it does not address the major funding problem most public pension systems currently face. On the contrary, it can *raise* annual costs by making it harder for a state to pay down those existing liabilities, because the plan will include fewer employees and fewer contributions going forward. (This would become particularly problematic if GASB adopts proposed rules that would significantly reduce allowed amortization periods.)

In addition, a defined-contribution plan is a more expensive way to provide a given level of retirement income to employees because it lacks the benefits of improved investment returns that result from a pension trust fund's pooled investments, professional money managers, and shared administrative costs.

One advantage of defined contribution plans often cited by proponents is that they reduce risk for the employer, who faces no future liability once the contributions are made. This reduction in risk, however, is a major disadvantage from the point of view of individual employees who now face the risks of inadequate retirement income or outliving their retirement savings.

Another argument for defined-contribution plans is that younger employees are less likely to remain in one job for many years and are attracted by the portability of individual retirement accounts. This desire for flexibility, however, may not be enough to offset the shift in risk from the employer to the employee, as well as other problems with defined-contribution plans. In addition, the experience of states that offer employers a choice between defined benefit and defined contribution plans shows that, when given a choice, most public employees prefer defined benefit plans.

Some states have tried to get the best of both the defined-contribution and defined-benefits approaches by creating a hybrid that provides a reduced defined-benefit plan in addition to a defined-contribution plan. Michigan (in its teachers'plan) and Utah recently adopted this approach, and other states are considering it. (Utah gives employees the option to go completely to a defined-contribution plan.) This reduces the risk for employees somewhat. Another way to mitigate some of the risk of defined contribution plans is to include provisions like automatic enrollment, matching employer contributions and access to investment managers. None of these provisions, however, give employees participating in a defined contribution plan the same level of retirement security as those in a defined benefit plan.

States and local governments considering defined-contribution or hybrid plans solely for the purpose of saving money would be well advised to look carefully at the experience of other states. For example, Utah's employer contribution under its new plan (10 percent of payroll) is higher than the contributions that a number of states typically make to their defined-benefit plans. In addition, Nevada decided against putting new hires in a defined-contribution plan when projections showed that the state's total pension costs would increase, since the state would have to increase its contributions to offset the loss of these new employees to the state's defined-benefit plan.[4] Similarly, Kentucky found that conversion to a defined-contribution plan would increase the state's costs for close to 20 years.[5]

Conclusion

There is no need for the federal government to take actions that could result in undesirable changes in state and local pension plans. Proposed federal requirements would undercut the GASB process to set standards on which financial markets rely, and is unnecessary because market discipline will enforce the new GASB standards. In addition to being unnecessary, the requirements would have a number of undesirable effects including sowing public confusion and thereby forcing states and localities to make larger than necessary reductions in vital services or increases in taxes, potentially spooking bond markets and raising the cost of borrowing for states and localities, and requiring creation of an entirely new federal bureaucracy at a time when additional federal spending can least be afforded.

A combination of the recovery of market losses sustained during the recession, modest increases in employer (and in some cases) employee contributions, and moderate restructuring of benefits should be able to restore the vast majority of state and local pension plans to full solvency.

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[4] The Segal Company, *Public Employees' Retirement System of the State of Nevada: analysis and Comparison of Defined Benefit and Defined Contribution Plans*, 2010.

[5] "Actuarial Analysis of Senate Bill 2 GA", Letter to Mr. William A. Theilen, COO, Kentucky Retirement Systems, revised February 25, 2011.